representing an estimate of its liability to its managers for so-called "quality bonuses."

2. Whether the failure of the government to provide petitioner with prior written notice of a second inspection of its 1955 books and records pursuant to Code § 7605(b) invalidates a deficiency assessment for fiscal 1955, where the second inspection of petitioner's 1955 books (which were voluntarily turned over) was incident to a necessary examination of its 1956 books.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1954:

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) *General Rule.*—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

* * * * *

[26 U.S.C. 461.]

SEC. 7605. TIME AND PLACE OF EXAMINATION.

* * * * *

(b) *Restrictions on Examination of Taxpayer.*—No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

[26 U.S.C. 7605.]

Treasury Regulations on Income Tax:

> SEC. 1.461–1(a)(2). * * * Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * *

STATEMENT

This case presents two discrete issues, one substantive and the other procedural. The first is whether, under petitioner's newly adopted method of compensating its salesmen and sales managers, it is entitled to accrue and deduct in fiscal 1955 and 1956 amounts representing estimated quality bonuses payable in the future. If, as the government contends, the deductions were not proper, the second issue is whether the deficiency notice for fiscal 1955 is defective for procedural reasons.

1. Petitioner published and sold encyclopedias ("World Book" and "Childcraft") door to door, receiving payment in installments. Prior to petitioner's fiscal year 1955, all salesmen and regional and district managers were compensated solely by means of a specified commission payable on each "bona fide" sale. A sale became "bona fide" when the customer paid a specified amount ($30) within a specified time (15 months). Salesmen were given advances against future commissions, but petitioner was not obligated to pay any commission on an order until it became "bona fide." Under this method of paying commissions petitioner did not accrue commission expense for federal tax purposes until the

bonafication period had expired, since petitioner recognized that until the bonafication requirement was satisfied "the commission might never actually become a liability."

Under new contracts effective at the beginning of fiscal 1955 the salesmen's commissions were reduced slightly in amount but were made payable immediately upon acceptance of the order. Managers likewise received slightly reduced commissions payable immediately upon acceptance of an order,[1] but managers also became entitled to a new item of compensation, called a "quality bonus" (the deductibility of which is here in question). The total amount of commissions and quality bonuses under the new contracts was equal to the total amount of commissions payable under the old contracts, *i.e.*, $49.

A quality bonus was computed as follows: At the time a sale was made the district and division managers' accounts were tentatively credited with a total of $7. If the customer did not make at least two of the first six required monthly payments, the managers accounts would be charged for $49. At the end of each three-month period the managers would be paid a

[1] Because the commissions under the new contracts were payable upon acceptance of the order, petitioner was entitled to a tax deduction much sooner than under the old contracts. Indeed, in fiscal 1955, petitioner was able to deduct commissions on sales orders accepted during that year under the new contracts, as well as commissions on orders accepted in earlier years which became bona fide in that year under the old contracts. The Court of Claims found that the tax saving caused by the accelerated deductibility of commissions was one of the reasons which prompted petitioner to change its system of compensation. (Pet. 22a.)

quality bonus if their credits in this account exceeded the charges for that period. Of course, a slight variation in the percentage of orders becoming bona fide would have a greatly magnified effect on the managers' quality bonuses, because the managers had a potential credit of $7 for each successful sale as opposed to a net charge of $42 ($49 charge less $7 credit) for each aborted sale.

Petitioner sought to deduct in each of its fiscal years 1955 and 1956 an estimated amount representing quality bonuses it expected to pay in the future on sales already contraced but not yet bona fide. This was computed by taking the amount of quality bonuses tentatively credited to managers and deducting an estimated amount which petitioner, on the basis of its experience, expected to be charged against managers in the future for those sales already contracted which would not become bona fide. The Internal Revenue Service disallowed the claimed deduction for estimated future quality bonuses.

2. In March, 1957, a revenue agent audited petitioner's fiscal 1955 federal income tax return. He had not previously audited petitoner and was unfamiliar with the voluminous records it maintained. He inquired concerning petitioner's $14,867,640 deduction for salaries and wages (which *sub silentio* included the claimed deduction for estimated future quality bonuses). Petitioner supplied the agent (1) with a written explanation of the new contracts which did "not mention the 'quality bonus'" and (2) with a copy of a salesman's, but not a manager's, contract (only managers' contracts mentioned quality bonuses). There-

fore, the agent never learned of the existence of petitioner's new quality bonus system.

In August, 1958, another revenue agent (Miss Mortenson) commenced an examination of the petitioner's fiscal 1956 return. She requested and received a full set of new contracts, including those with managers which provided for quality bonuses. During the course of her examination, petitioner voluntarily made its records for fiscal 1955, as well as for fiscal 1956, available to her so that she could understand the 1956 opening balances and the working of the new quality bonus system. She then raised questions concerning the proper time for accruing quality-bonus deductions with petitioner's representatives, and in October, 1958, Agent Mortenson asked petitioner's representatives to consent to an extension of the period of limitations on the assessment of deficiencies for fiscal 1955, which would otherwise expire on December 15, 1958. Petitioner's representatives refused. On December 11, 1958, the Commissioner served petitioner with an official written notice that a re-examination of its fiscal 1955 return would be made, and, on the following day, a statutory notice of deficiency for that year was issued. (Pet. 1a-41a.)

ARGUMENT

1. *Premature Accrual of Deductions for Quality Bonuses.* The decision of the court below on the accrual of quality bonuses is correct, the case turns on its peculiar facts, and there is no conflict of decisions.

The issue presented here is solely one of timing, *i.e.* whether petitioner is entitled to a deduction for quality bonuses at the time of each sale or at the end of

the bonafication period. All the courts to pass on such questions (including the lower court in the instant case) agree on the controlling legal principles. Petitioner is entitled to deduct accrued quality bonuses in "*the taxable year in which all the events have occurred which determine the fact of the liability* and the amount thereof can be determined with reasonable accuracy." Treas. Reg. § 1.461–1(a)(2) (emphasis added). However, no deduction will be allowed for an estimated future expense before it becomes a fixed liability. *Brown* v. *Helvering*, 291 U.S. 193. This case involves the application of these settled principles to petitioner's unusual quality-bonus system.

Petitioner sold most of its encyclopedias on the installment method. Under the quality-bonus system its sales managers would receive a bonus only if the vast majority of sales in their area were substantially completed rather than aborted after a few payments.[2] The purpose of the system was to encourage the managers to train and supervise their salesmen to concentrate on making sales that would be substantially completed. The managers were given a quality bonus of $7 for each sale that became bona fide (*i.e.*, upon which the requisite number of payments were made) and were penalized $42 for each sale that did not reach the requisite stage of maturity. Thus, the managers as a group would not receive a quality bonus

[2] Petitioner's quality bonus system is tailored to its highly unusual method of doing business. Petitioner employed more than 20,000 part time salesmen and paid them a 32% commission upon the makings of a sale requiring only a $10 down payment. Thus petitioner felt that its quality bonus system would encourage close managerial supervision of its large part-time sales force in order to avoid carelessness and possible fraud.

unless more than 6 sales became bona fide for every one that aborted. The quality-bonus system was carefully designed to compensate the managers not on the basis of individual sales, but on the basis of the overall performance of their territories during an extended period of time. Because of the interrelationship between the sales in determining the amount of the bonus—each sale which aborted before the requisite payments were made washed out the quality bonus otherwise payable on 6 sales which actually became bona fide—it was impossible to determine whether there would be any quality bonuses until 6 months after the sales were made—*i.e.*, the end of the bonafication period. On these facts the lower court correctly concluded that petitioner's liability for a quality bonus was not fixed at the time of a particular sale, but that because of the interrelationship between transactions the liability for a bonus did not become fixed until expiration of the six-month bonafication period.[3]

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[3] In fact, petitioner acknowledged that its claimed deduction was merely a statistical estimate of the amount it would have to pay as quality bonuses. It sought a deduction for accrued quality bonus credits which had not, at the end of its fiscal year, become bona fide, less an estimated amount which, on the basis of its experience, it expected to charge against managers in the future for sales which would not become bona fide. This Court has recently held that the Commissioner need not accept such estimates in computing taxable income (*American Automobile Assn.* v. *United States*, 367 U.S. 687), and the same principle applies to deductions. *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, *per curiam*, vacating and remanding 283 F. 2d 279 (C.A. 7), 293 F. 2d 628 (C.A. 7), certiorari denied, 368 U.S. 976; see *Simplified Tax Records, Inc.* v. *Commissioner*, 41 T.C. 75, 79.

Petitioner claims that the instant decision conflicts with *Ohmer Register Co.* v. *Commissioner,* 131 F. 2d 682 (C.A. 6). That case involved ordinary sales commissions, and is thus radically different than the instant case. The Ohmer Register Co. credited each salesman with a commission based on the amount of each sale made by him. If the customer breached the contract after making only part payment, the salesman's account would be charged with a pro-rata portion of the commission. Under this system the salesman's commission was computed separately on each sale. The court thus held that as each sale was made, Ohmer's liability for a commission on that sale became fixed, and that the possibility that the buyer's later breach might affect the amount of the commission on that sale should not defeat accrual.

Both the lower court in the instant case and the court of appeals in *Ohmer* agreed on the controlling principles of law. Only because petitioner's unusual quality-bonus system was so radically different from the ordinary sales commissions in the *Ohmer* case did the lower court find that petitioner was not entitled to a deduction. Indeed, the Court of Claims in the instant case pointed out the crucial factual difference:

> * * * [I]n *Ohmer,* each individual order (upon shipment) gave rise to liability for a commission. With regard to the case at bar, we have already indicated that a quality bonus was based not upon an individual sale, but upon the overall experience within the manager's territory for a given quarter. * * * [Pet. 5a–6a.]

There is thus no conflict between cases like *Ohmer* dealing with ordinary salesmen's commissions and the instant case.

If petitioner had agreed to pay its managers a bonus based on its net income for the year 1955, it would not have been entitled to accrue a deduction as it made each individual sale. See *Kaufman Dept. Stores, Inc.* v. *Commissioner*, 34 F. 2d 257 (C.A. 3). The net profit on a dozen advantageous sales may be offset by the loss on a single disadvantageous transaction. In computing a bonus based on the net profit for an entire year, the necessary interrelationship between all the transactions for that year prevents the liability from being regarded as fixed as each separate sale occurs. Only at the end of the year can a bonus based on net profits be accrued. In terms of this crucial factor—*i.e.*, the interrelationship between transactions—petitioner's quality-bonus plan was much closer to a bonus based on net income than it was to an ordinary salesman's commission (which, as in *Ohmer*, can be computed separately on each sale). The lower court was, therefore, correct in deciding that petitioner's liability could not be regarded as fixed until the expiration of the six-month bonafication period.

The court's decision turns on the peculiar facts of petitioner's unusual quality-bonus system. There is no disagreement on the applicable legal principles and no conflict of decisions.

2. *Validity of the 1955 Deficiency Notice.* The decision of the lower court on this procedural issue (relating only to the fiscal 1955 deficiency) is correct,

and there is no direct conflict with any appellate decision.

Section 7605(b) of the Code provides that:

> * * * only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an added inspection is necessary.

Petitioner contends that the section must be read literally to prohibit Agent Mortenson from inspecting petitioner's 1955 books (during her audit of petitioner's 1956 return), because they had previously been inspected by another agent; that petitioner's decision to voluntarily give its 1955 books to Agent Mortenson should not constitute a waiver; and that the Court should read into the section an additional provision that any deficiency notice based on information obtained in violation of § 7605(b) is invalid. We disagree with all three contentions.

The purpose of § 7605(b) was to prevent taxpayers from suffering "petty annoyances" due to frequent re-examination of their books by low-echelon revenue agents. 61 Cong. Rec. 5855, quoted in *United States* v. *Powell*, 379 U.S. 48, 54–55. Viewed in this light, it is, we submit, clear why Congress did not provide any sanction for violation of the section. If a taxpayer was "annoy[ed]" by a revenue agent's request to re-examine his books, the taxpayer could refuse to produce them. The agent would then have to get clearance from his superior (*United States* v. *Powell*, *supra*, at 55–56) or drop the request. The taxpayer

could defeat any attempt to subpoena the records without a re-examination letter by merely citing § 7605(b) to the enforcing court. See *McDonnell* v. *Commissioner*, 6 B.T.A. 685; *Philip Mangone Co.* v. *United States*, 54 F. 2d 168 (Ct. Cl.); *Glassell* v. *Commissioner*, 42 F. 2d 653 (C.A. 5); *Sutor* v. *Commissioner*, 17 T.C. 64; *Rife* v. *Commissioner*, 41 T.C. 732. If, on the other hand (as in the instant case), the agent's examination did not "annoy" the taxpayer, § 7605(b) is never called into play. We submit that § 7605(b) was never intended to invalidate a correct deficiency notice, but merely to *permit* a taxpayer who wishes to do so to refuse an agent access to records that have once been examined, unless a supervisor approves.[4]

The vast majority of the courts have construed § 7605(b) as meaning no more than that a taxpayer who is annoyed by a re-examination may, if he asserts his right, refuse the agent access to his books. See

[4] Moreover, in the instant case a re-examination letter was served on petitioner before issuance of the deficiency notice. Certainly Congress did not intend § 7605(b) to mean that if Agent Mortenson (the second agent) examined petitioner's 1955 books without having first obtained a re-examination letter, the Service would be forever barred from issuing such a letter and again re-examining petitioner's 1955 books. Therefore, if, after issuance of the re-examination letter on Dec. 11, 1958, Agent Mortenson had again examined petitioner's 1955 books and obtained the information necessary for the deficiency notice, petitioner could not invoke § 7605(b) to invalidate the deficiency. It would exalt form over substance to hold the deficiency notice invalid because Agent Mortenson did not perform the unnecessary task of again re-examining petitioner's books after service of the re-examination letter, but instead used the information gathered before issuance of the letter.

cases cited *supra*, p. 12. Only the Seventh Circuit has departed somewhat from this rationale, *Reineman* v. *United States*, 301 F. 2d 267 (C.A. 7), and its decision is not in conflict with the instant case. In *Reineman* one revenue agent had fully examined the taxpayer's 1954 return. Another agent, during a subsequent examination of taxpayer's 1955 return, looked at taxpayer's 1954 books without taxpayer's knowledge, and assessed a deficiency for 1954. The court held the deficiency notice invalid because the second agent had violated § 7605(b). While we do not agree with the decision (for the reasons stated *supra*, pp. 11–12), it is clear that the Seventh Circuit would not have quashed the 1955 deficiency notice issued to petitioner. In its *Reineman* opinion that court stated that it fully agreed with the numerous cases (cited *supra*, p. 12) holding that where taxpayers knew that the second agent was looking at their books for the earlier year (here 1955) and "either failed to object or voluntarily consented," then the "taxpayers have waived their rights under" § 7605(b). 301 F. 2d at 272. However, the court stated that Reineman had been "totally unaware" that the second agent was looking at his 1954 books. *Id.* at 271. Finally, the Seventh Circuit noted that Reineman had not engaged in any "conscious action * * * to mislead" the first agent who had examined his 1954 books.

The instant case is thus distinguishable from *Reineman* on two grounds that the Seventh Circuit thought crucial. Petitioner "voluntarily furnish[ed] * * * its 1955 records" to Agent Mortenson (the second agent) (Pet. 10a). And partially because of

petitioner's failure to make full disclosures in reply to the first agent's questions, he had "not actually learn[ed] of the existence of the [new] quality-bonus system" (Pet. 10a). Therefore, while the Seventh Circuit's *Reineman* decision is not completely consistent in principle with the vast majority of the decisions on § 7605(b), the Seventh Circuit would nevertheless have reached the same correct result as the lower court.

CONCLUSION

For the foregoing reasons the petition for a writ of certiorari should be denied.

Respectfully submitted.

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